

IT 00-14

Tax Type: Income Tax

Issue: Responsible Corporate Officer – Failure to File or Pay Tax

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS,**

v.

**JOHN DOE, FRANK DOE and
RICHARD DOE
Responsible Officers for ABC Exteriors, Inc.,
Taxpayer**

No.
NOD 0000 (JOHN DOE)
NOD 1111 (FRANK DOE)
NOD 2222 (RICHARD DOE)
Period: 3/Q/94, 2/Q/95 – 1/Q/96

**Ted Sherrod
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Attorney General Shephard Smith on behalf of the Illinois Department of Revenue; Thomas Arends, Esq. of Richard M. Columbik & Associates, on behalf of JOHN DOE, FRANK DOE and RICHARD DOE.

Synopsis:

This matter arose after the Illinois Department of Revenue (“Department”) issued a Notice of Deficiency (“NOD”) to JOHN DOE (NOD 0000), FRANK DOE (NOD 1111) and RICHARD DOE (NOD 2222) regarding the corporate tax liability of ABC Exteriors, Inc. All three individuals timely protested the NODs that were issued, and requested a hearing. Pursuant to a prehearing order, the parties identified the issues to be resolved at the hearing as “whether any one or all of the taxpayers were the persons required to collect, truthfully account for and pay over tax imposed” by the Illinois

Income Tax Act on ABC Exteriors, Inc. and “who willfully attempted in any manner to evade or defeat such tax or the payment thereof” for the periods 3/Q/94, 2/Q/95 through 4/Q/95 and 1/Q/96 (“tax period”). Following submission of evidence and a review of the record, it is recommended that Notices of Deficiency issued to FRANK DOE (NOD 1111) and RICHARD DOE (NOD 2222) be cancelled, and the Notice of Deficiency issued to JOHN DOE (NOD 0000) be affirmed and finalized as issued.

Findings of Fact:

1. The Department’s *prima facie* case was established by the admission into evidence of: a) Notice of Deficiency 0000, dated March 16, 1999, showing a proposed liability for JOHN DOE in the amount of \$77,358.02 for the 3/Q/94, 2/Q/95 through 4/Q/95, and 1/Q/96; b) Notice of Deficiency 1111, dated March 16, 1999, showing a proposed liability for FRANK DOE in the amount of \$77,358.02 for the 3/Q/94, 2/Q/95 through 4/Q/95 and 1/Q/96, and c) Notice of Deficiency 2222, dated March 16, 1999, showing a proposed liability for RICHARD DOE in the amount of \$77,358.02 for the 3/Q/94, 2/Q/95 through 4/Q/95 and 1/Q/96. Dept. Ex. Nos. 1, 2, 3.
2. During the tax period in issue, ABC Exteriors, Inc. (“ABC”) was an Illinois corporation engaged in the business of roofing, and gutter and siding contracting. Taxpayer’s Ex. 7.
3. JOHN DOE was President of ABC, and owned 50 percent of the company’s stock.¹ Tr. p. 43.
4. FRANK DOE was Secretary of ABC and owned 50% of the company’s stock. Dept. Ex. 4; Tr. p. 42.

¹ Unless otherwise noted, findings of fact apply to the tax period.

5. RICHARD DOE was an employee of ABC. He was not an officer and had no equity interest in the company. Tr. pp. 14, 16.
 6. JOHN DOE was responsible for preparing the withholding tax returns and paying the withholding tax for ABC. Tr. p. 43.
 7. JOHN DOE was also responsible for overseeing the financial obligations of ABC. Tr. p. 23.
 8. JOHN DOE decided which bills would be paid and how much would be paid. Tr. p. 44.
 9. ABC had a checking account at ONLY BANK in ANYWHERE. Tr. p. 43.
 10. JOHN DOE was the sole signatory on the ABC bank account at ONLY BANK. Tr. p. 43.
 11. FRANK DOE functioned in the capacity of the company's "field foreman". His primary duty was "running the people out in the field, making sure that they knew where they were going, the material they needed so they could do their job." Tr. pp. 18, 19.
 12. FRANK DOE was not involved with the financial affairs of the company during the first quarter of 1996 or at any other time. Tr. pp. 18, 21.
 13. FRANK DOE signed ABC's withholding tax return for the first quarter of 1996. He did not prepare this return, and signed it only because "JOHN was out of town." Tr. pp. 19, 20, 21.
 14. RICHARD DOE was primarily responsible for ordering materials. He was not involved with the preparation or filing of any federal or state tax returns, or in any other financial matters of the company. Tr. p. 14.
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- 15.** On May 1, 1996, ABC entered into an “ASSET PURCHASE AGREEMENT” with Exteriors, Inc. (“Exteriors”), an Illinois corporation. Taxpayer’s Ex. 7; Tr. p. 25.
- 16.** ABC did not receive any cash from Exteriors; the sole consideration for the assets Exteriors purchased was Exteriors’ assumption of ABC liabilities. Tr. pp. 36, 37.
- 17.** Exteriors agreed to assume all liabilities of ABC. These liabilities were to be paid from receivables owed to ABC and collected by Exteriors after May 1, 1996. Tr. pp. 36, 37.
- 18.** The “ASSET PURCHASE AGREEMENT” indicates that Exteriors assumed liability for the first quarter of 1993, the second through fourth quarters of 1995, the first quarter of 1996 and April 1996. Taxpayer’s Ex. 8, 9.
- 19.** ABC, through its attorney, notified the Department that it was going to sell ABC’s assets to Exteriors. Taxpayer’s Ex. 10.
- 20.** On July 1, 1996, the Department issued Bulk Sales Stop Order No. B52444 (“Stop Order”) to Exteriors. Taxpayer’s Ex. 11; Tr. p. 36.
- 21.** The Stop Order notified Exteriors that the Department claimed a lien against Exteriors in the amount of \$134,400. Taxpayer’s Ex. 11.
- 22.** On July 29, 1996, the Department’s Bulk Sales Section notified Exteriors that, pursuant to the Stop Order, the Department “now demands that you remit the following amounts to pay amounts due from the transferor of the assets you acquired from the portion of the proceeds that you were required to withhold:...Illinois Withholding Tax...(\$53186.47”.
- 23.** Exteriors was owned by Richard Rosenow. Taxpayer’s Ex. 7; Tr. p. 40.

24. After the assets of ABC were sold to Exteriors, Richard Rosenow took custody of and maintained the books and records of ABC. Taxpayer's Ex.7; Tr. p. 40.

25. JOHN DOE produced no cancelled checks or any other evidence showing that ABC's withholding tax for the third quarter of 1994 was paid. Tr. pp. 42, 43.

Conclusions of Law:

The issue in this case is whether JOHN DOE, FRANK DOE or RICHARD DOE were responsible persons who willfully failed to collect, truthfully account for and pay over withholding tax for ABC as required by statute, and are, therefore, personally liable for the penalty imposed by Section 1002(d) of the Illinois Income Tax Act, 35 ILCS 5/101 *et seq.* Section 1002(d) provides that a penalty may be imposed by Section 3-7 of the Uniform Penalty and Interest Act ("UPIA") which, in turn, provides as follows:

(a) Any officer or employee of any taxpayer subject to the provisions of a tax Act administered by the Department who has the control, supervision or responsibility of filing returns and making payment of the amount of any trust tax imposed in accordance with that Act and who willfully fails to file the return or make the payment to the Department or willfully attempts in any other manner to evade or defeat the tax shall be personally liable for a penalty equal to the total amount of tax unpaid by the taxpayer including interest and penalties thereon. The Department shall determine the penalty due under this Section according to its best judgment and information, and that determination shall be *prima facie* correct and shall be *prima facie* evidence of a penalty due under this Section.

35 ILCS 735/3-7

To impose personal liability for the failure to pay withholding taxes, it must be shown that the person is a responsible party and that the failure to pay was willful. By introducing the notices of deficiency into evidence, the Department established its *prima facie* case against the taxpayer. In Branson v. Department of Revenue, 168 Ill.2d 247 (1995), the Illinois Supreme Court held that the admission of the Notice of Penalty

Liability into evidence established all of the statutory requirements for imposition of the penalty, including willfulness. While the court was addressing Section 13 ½ of the Retailers' Occupation Tax Act ("ROT") 35 ILCS 120/1 et seq., rather than the Section 3-7 of the UPIA, Section 3-7 replaced Section 13 ½ when Section 13 ½ was repealed effective January 1, 1994. Id. A comparison of Section 13 ½ of the ROT, and Section 3-7 of the UPIA reveals these sections are almost identical, and both enumerate corporate officers and employees tax liability. Moreover, both address willfulness and responsibility. Therefore, a similar analysis of Section 3-7 of the UPIA, based on the court's conclusions may be made. Frowner v. Chicago Transit Authority, 25 Ill. App. 2d 312 (1960). Applying Branson, the burden of proof shifted to the taxpayer to offer competent evidence to rebut the Department's *prima facie* case. Id.

In determining whether an individual is a responsible person the courts have indicated that the focus should be on whether that person has significant control over the business affairs of a corporation and whether he or she participates in decisions regarding the payment of creditors and the disbursement of funds. *See, e.g. Monday v. United States*, 421 F. 2d 1210 (7th Cir. 1970), cert. denied 400 U.S. 821 (1970). Liability attaches to those with the power and responsibility within the corporate structure for seeing that the withholding taxes are remitted to the government. Id. Thus, the statute does not confine liability to the single most responsible person. *See, Gephart v. United States*, 818 F. 2d 469 (6th Cir. 1987).

With regard to FRANK DOE, the record shows that he was an employee and officer of ABC, and a 50 percent owner, as was his brother JOHN. His responsibilities were limited to acting in the capacity of the company's "field foreman". He had no

signatory authority on the company's bank account, nor did he have any role in decisions regarding the payment of creditors. Rather, JOHN DOE had the sole responsibility for the financial affairs of the company, including the preparation of the company's tax returns. FRANK DOE did sign one withholding tax return for JOHN DOE; however this was done for convenience when JOHN DOE was out of town. FRANK DOE did not take any part in the preparation of tax returns, nor did he normally sign returns. Moreover, the record does not reflect that FRANK DOE ever wrote checks for any corporate expenses during the tax periods in controversy. Based on the foregoing, FRANK DOE did not have sufficient control over the company's finances or operations to establish him as a responsible party, and has presented sufficient evidence to rebut the Department's *prima facie* case.

With regard to RICHARD DOE, the record shows that he was an employee, but not an officer of the corporation and had no equity interest in it. RICHARD DOE's primary responsibilities were ordering materials used in the conduct of the company's business. Credible testimony was presented that RICHARD DOE did not participate in the company's financial decisions. He did not have signatory authority on the company's bank account and did not have any role in decisions regarding the payment of creditors. He took no part in the preparation of returns, and did not sign any returns or checks. Based on the foregoing, RICHARD DOE did not have sufficient control over the company's finances or operations to establish him as a responsible party. Consequently, RICHARD DOE presented sufficient evidence to rebut the Department's *prima facie* case.

With regard to JOHN DOE, the evidence clearly proves that he had significant control over the corporation's business operations and financial affairs. He was President of the company during the entire tax period, and owned 50 percent of its stock. The record also shows that JOHN DOE was charged with and exercised overall responsibility for its financial affairs. He was exclusively responsible for filing the company's tax returns, and decided which creditors would be paid. As he had exclusive check signing authority, only he could sign the checks to pay corporate bills, and to remit taxes to the State of Illinois. The foregoing facts clearly show that JOHN DOE wielded sufficient power within the corporate structure to establish him as a responsible person under the statute.

It must also be determined whether JOHN DOE willfully failed to remit the withholding taxes to the Department within the meaning of the statute. Willful as applied in Section 6672 of the Internal Revenue Code, and hence Illinois Income Tax Act , Section 1002(d) (*see Department of Revenue v. Heartland Investments*, 106 Ill. 2d 19, 29 (1985)), encompasses a reckless disregard for obvious and known risks. *Id.* Willfulness in regards to Section 1002(d) is not merely limited to "intentional, knowing and voluntary acts." *Monday*, 421 F. 2d at 1215. In the case of *Wright v. United States*, 809 F.2d 425, 427 (7th Cir. 1987), the Seventh Circuit Court of Appeals held that a "responsible person" is liable if he (1) clearly ought to have known that (2) there was a grave risk that withholding taxes were not being paid and (3) he was in a position to find out for certain. Willfulness also includes a "failure to investigate or to correct mismanagement after having notice that withholding taxes have not been remitted to the Government." *Peterson v. United States*, 758 F. Supp. 1209, 1217 (N.D. Ill. 1990).

As previously noted, the Department established its *prima facie* case of liability for willfully failing to file and pay taxes under the statute when the certified copy of the Notice of Deficiency was entered into evidence. See Branson v. Dept. of Revenue, 168 Ill. 2d 247 (1995). The presumption of willfulness is rebutted only if evidence sufficient to disprove that the corporate officer acted willfully is introduced. Id.

JOHN DOE introduced no evidence to rebut the presumption that he willfully failed to pay tax due for the third quarter of 1994. While he testified that this tax was paid (Tr. p. 24), he produced no evidence of payment.

With respect to the other tax periods at issue, JOHN DOE attempted to rebut the presumption of willfulness by introducing evidence that Exteriors assumed responsibility for paying ABC's withholding taxes for all of the tax periods in controversy except the third quarter of 1994, when it purchased the assets of ABC on May 1, 1996. He testified that he believed these tax obligations to the Department had been satisfied in full by Exteriors pursuant to the terms of the ASSET PURCHASE AGREEMENT which provided that Exteriors assumed liability for withholding taxes due for all of the tax periods in controversy except the third quarter of 1994. During his testimony, he noted that the Department's Bulk Sales Stop Order, and its subsequent letter of July 29, 1996, notified Exteriors of its liability for these taxes, and concluded that he was justified in assuming from these documents that ABC's obligations to the Department would be satisfied by Exteriors.

ABC's liability for withholding tax attached at the time it deducted or was required to deduct from wages paid to its employees. See 35 ILCS 5/706. The responsible officer has a duty to keep these taxes in trust from the day the taxes were

withheld or required to be withheld. Id. JOHN DOE delegated responsibility for collecting accounts receivable due ABC that were to be used to pay tax, and he also delegated responsibility for paying the tax due from these receivables. He did this even though there were no assurances that the receivables would be collected or that money would be available to pay the taxes that were due, or that Exteriors would even comply with its contractual duties, which it obviously did not. Although he transferred the books and records of ABC to the owner of Exteriors, and apparently relinquished his authority over the affairs of the company after May 1, 1996, JOHN DOE cannot avoid responsibility for this duty by delegating it to a third party. Hornsby v. IRS, 588 F. 2d 952 (5th Cir. 1979); Thomsen v. United States, 887 F. 2d 12 (1st Cir. 1989). He had a duty to assure that the tax return filings and payments satisfying these tax obligations of ABC, that arose prior to the date the assets of this company were sold, were met. However, there is nothing in the record to indicate that he ever took any steps to verify that these taxes were paid.

Given his responsibility within the corporation, he should have investigated whether the company's taxes were being properly remitted to the Department. The fact that he adopted a "hear no evil – see no evil" policy does not relieve him of liability. Wright v. United States, 809 F. 2d 425 (7th Cir. 1987); accord, Calderone v. United States, 799 F. 2d 254, 260 (6th Cir. 1986), *quoting* Bolding v. United States, 565 F. 2d 663, 674 (1977) ("Thus, it cannot be that 'a responsible officer may immunize himself from the consequences of his actions by wearing blinders which shut out all knowledge of the liability for the nonpayment of (the corporation's) withholding taxes.' ").

The transfer of responsibility to Exteriors was made without seeking any assurances that the company's tax obligations were paid. He could easily have fulfilled this responsibility by asking Exteriors to provide him with evidence of tax payments. JOHN DOE clearly had the authority to demand that these obligations be satisfied by Exteriors, since Exteriors' failure to do so would have constituted a breach of the terms of the ASSET PURCHASE AGREEMENT pursuant to which Exteriors agreed to pay these taxes. However, JOHN DOE failed to do this, or to take any other steps to see that the company's tax obligations had been met. These omissions are sufficient to establish willfulness within the context of the statute.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notices of Deficiency issued to FRANK DOE (NOD 1111) and to RICHARD DOE (NOD 2222) be cancelled, and that the Notice of Deficiency issued to JOHN DOE (NOD 0000) be affirmed and finalized as issued.

Ted Sherrod
Administrative Law Judge

Date: July 19, 2000